

RD AN No. 4053 (1980-D)
February 28, 2005

TO: All State Directors
Rural Development

ATTENTION: Rural Housing Program Directors, Rural Development Managers,
Guaranteed Rural Housing Coordinators, and Community Development
Managers

FROM: Russell T. Davis *(Signed by Russell T. Davis)*
Administrator
Rural Housing Service

SUBJECT: Single Family Housing Guaranteed Loan Program (SFHGLP)
Debt Ratios Waivers

PURPOSE/INTENDED OUTCOME:

The purpose of this Administrative Notice (AN) is to elaborate upon the use of debt ratio waivers when approving loan guarantees under the SFHGLP and RD Instruction 1980-D, section 1980.345. This AN provides information on potential compensating factors, including credit scores, to be used by the Agency when evaluating a lender's request for a debt ratio waiver.

COMPARISON WITH PREVIOUS AN:

This AN replaces AN No. 3936 (1980-D) dated February 10, 2004. Minor changes have been made to clarify that debt ratio waivers should be issued only if there are no additional and significant layers of risk.

EXPIRATION DATE:
February 28, 2006

FILING INSTRUCTIONS:
Preceding RD Instruction 1980-D

BACKGROUND:

Monthly debt-to-income ratios are widely used in the home mortgage industry as a measure of the applicant's cash flow or repayment ability. Two ratios are routinely calculated: 1) the "PITI" ratio consisting of the proposed monthly loan payment of principal, interest, taxes, and insurance (PITI) divided by the applicant's gross monthly income, and 2) the total debt or "TD" ratio consisting of the applicant's total long term debt obligations, including the proposed monthly loan PITI payment, divided by the gross monthly income. In the SFHGLP, an applicant meets Agency requirements for repayment ability when the applicant's PITI ratio is less than or equal to 29 percent and the TD ratio does not exceed 41 percent.

In the home mortgage industry it is common for underwriters to make exceptions to both the TD and the PITI ratio requirements. The exceptions are based on the total strength of the application and the applicant's credit worthiness, which aside from debt ratios, include variables such as employment stability and credit history. Each loan application is a separate and unique transaction composed of many factors other than the debt ratios. Debt ratio exceptions are feasible when an applicant demonstrates compensating factors indicating the capacity, willingness, and ability to pay mortgage payments in a timely manner. Generally, the stronger the compensating factors, the more flexibility there will be in debt ratio exceptions. There is not a maximum amount that the ratio standards may be exceeded. Depending on the strength of the compensating factors, PITI ratios in the mid to high 30s and TD ratio waivers in the mid to high 40s are not uncommon.

It is important that all debt ratio waivers be issued in writing by Agency staff to lenders. Lenders requesting debt ratio waivers are responsible for documenting the compensating factors supporting the waiver. Agency staff may assist lenders in determining any compensating factors associated with loan applications. If requested by a lender, Agency staff may make a preliminary determination of the appropriateness of a ratio exception for individual SFHGLP application prior to the lender's submission of the file for a conditional commitment. In such cases, the Agency staff will notify the lender that preliminary ratio exception approvals are subject to a final review and approval by the Agency at the time of conditional commitment issuance.

IMPLEMENTATION RESPONSIBILITIES:

The National Office supports granting ratio waiver requests to applicants with legitimate compensating factors, if there are no additional and significant layers of risk associated with the application. The SFHGLP regulations authorize the Agency, at its discretion and on a case-by-case basis, to approve a lender's request for debt ratio exceptions. Specifically, RD Instruction 1980-D, section 1980.345(c)(5) states:

If the applicant's total debt ratio and/or PITI ratio exceed the maximum authorized ratio, the Lender may request Rural Housing Service (RHS) concurrence in allowing a higher ratio based on compensating factors. Acceptable compensating factors include, but are not limited to, the applicant having a history over the previous 12 month period of devoting a similar percentage of income to housing expense to that of the proposed loan,

or accumulating savings which, when added to the applicant's housing expense and shows a capacity to make payments on the proposed loan. A low total debt ratio, *by itself*, does not compensate for a high PITI. (Emphasis and underscore added).

Common Compensating Factors

Common compensating factors used by the Agency under RD Instruction 1980-D, section 1980.345(c)(5) include, but are not limited to:

- A. The borrower has demonstrated a conservative attitude toward the use of credit and ability to accumulate savings.
- B. Previous credit history shows that the borrower has the ability to devote a greater portion of income to housing expenses (i.e. the applicant has a history over the previous 12 month period of devoting a similar percentage of income to housing expense to that of the proposed loan, or accumulating savings which, when added to the applicant's housing expense, shows a capacity to make payments on the proposed loan).
- C. The borrower receives compensation or income not reflected in effective income, but directly affecting the ability to pay the mortgage, including food stamps and other similar public benefits.
- D. There is only a minimal increase in the borrower's housing expense.
- E. The borrower has substantial cash reserves after closing.
- F. The borrower has substantial non-taxable income not previously accounted for in the ratio computations.
- G. The borrower has potential for increased earnings, as indicated by job training or education in the borrower's profession.
- H. The home is being purchased as the result of relocation of the primary wage-earner and the secondary wage-earner has an established history of employment, is expected to return to work, and there are reasonable prospects for securing employment in a similar occupation in the new area. The underwriter must address the availability of such possible employment.
- I. A low TD ratio. A low TD ratio *by itself* does not compensate for a high PITI ratio, however, when other strong compensating conditions are present, a low TD ratio should be viewed as a positive mitigating factor.

Using Credit Scores as a Compensating Factor

An additional compensating factor is:

Fair Issac & Company (FICO) credit scores of 660 or higher. FICO scores of 660 or higher constitute a strong positive compensating factor that may be used by itself, or coupled with other common compensating factors, to justify a debt ratio waiver. Other compensating factors for a ratio waiver request may be listed, but need not be documented, if the FICO score is 720 or higher.

Debt ratio exceptions may also be considered and approved for loans with FICO scores under 660. A co-borrower with a credit score of 660 or higher is only one of many potential compensating factors. Indeed, borrowers with very low credit scores may still become successful homeowners and repay their SFHGLP as agreed.

Credit scoring technology is based on statistical models which assess how likely a borrower is to pay back a loan. A FICO credit score is based exclusively on data in a borrower's credit report. The borrower's information is measured against historical data from thousands of loan profiles and their respective loan repayment performances. The borrower is then assigned a "score" predicting their loan performance should credit be extended. Relative to the home mortgage industry, FICO scores have been found to be highly predictive. The National Office has been tracking FICO scores on a sample basis for both current and delinquent SFHGLP since 1998. Home mortgage industry statistics, as well as a study of SFHGLP by the National Office, indicate that borrowers with FICO scores over 660 historically experience far fewer defaults than borrowers with FICO scores under 660.

FICO scores are also known as Beacon scores, Empirica scores, and Fair Issac scores. One or more scores may be found on the applicant's credit report. If the applicant's credit report contains two scores, the lender should select the lower of the two scores as the underwriting score for that applicant. If the applicant's credit report contains three scores, the lender should select the middle score as the underwriting score for that applicant.

Similar treatment should be given to a co-borrower's credit score. If there is more than one applicant, the credit score of the primary wage earner should be emphasized. This does not mean, however, that a co-applicant's credit score should be completely ignored. Special caution should be taken if the co-applicant's FICO score is under 620. Debt ratio waivers may still be granted in such cases if there are strong compensating factors that significantly mitigate risk.

Ratio waivers should be considered for applicants with legitimate compensating factors such as those described above. The mere presence of compensating factors, however, should not automatically compel a ratio exception, especially when multiple layers of risk in the application are present. Denial of a lender's request for a ratio waiver is not an appealable decision, however, this adverse action may be reviewed if and when the guaranteed loan is denied for lack of repayment ability.

Should there be any comments or questions concerning this AN, please contact Joaquín Tremols or Victor McKoy at (202) 720-1452.